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SUBJECT: Turkey: Meetings with Turkish Delegation in Singapore

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Sensitive But Unclassified. Please handle accordingly.

1.(SBU) Summary: Your meeting with Minister Babacan occurs as Turkey looks forward to an autumn of potentially rocky EU accession issues, pre-election domestic politics and question marks about inflation -- any of which could roil financial markets, as they did in the spring. Turkey weathered the spring financial volatility, vindicating its overall policy framework. Public finances continue to improve, the current account deficit, while large, can be financed, and growth is expected to slow only slightly this year. For now, inflation is the most significant macroeconomic issue. End Summary.

After a Quiet Summer, Autumn Challenges

12. (SBU) This is a moment of transition for Babacan, Central Bank Governor Yilmaz and the Turkish economic team. The spring emerging market sell-off scared them, but the fact that the market correction did not turn into a crisis also vindicated Turkey's overall policy framework. After the Central Bank's missteps during the volatile period, the Bank's ultimate ability to stabilize the markets and the ensuing two months of relative calm have partially restored Governor Yilmaz' credibility. Now Babacan and Yilmaz are focused on the remainder of 2006: Babacan on avoiding a "train wreck" over Cyprus in Turkey's EU accession process and Yilmaz on returning the Turkish economy to its pre-correction disinflationary path.

13. (SBU) Babacan, normally a relatively technocratic, under-the-political-radar minister, has run into a barrage of press criticism in recent weeks over his perceived inactivity as EU negotiator. This criticism, and the looming EU deadline for Turkey to open its ports and airports to Greek Cypriot shipping and aviation, is likely to make him focus more on his EU negotiator job than on his macro policy responsibilities and the IMF program. The current relatively benign macro environment and the absence of major bones of contention with the IMF are likely to reinforce this tendency. Turkey has recovered well from the May-June fall in the exchange rate and spike in interest rates. To date, there is little evidence that the correction has scarred either the banking system or the corporate sector, despite initial fears to the contrary.

Biggest Macro Issue is now Inflation

14. (SBU) Public finances continue to benefit from a combination of

strong growth, a reduced interest bill, and cash receipts from privatizations and asset sales from intervened banks. From January through August, 2006 the central government actually ran a slight overall surplus - not bad for a country which had a budget deficit of 14% of GDP only four years ago. So far, there have been few signs of political spending in the run-up to elections though this remains a risk.

15. (SBU) Turkey's debt ratios are much improved from even two years ago: net public sector debt of 56% at yearend 2005, versus 90% in 2001. After the spring volatility, however, interest rates never returned to their pre-correction levels and rose again (surpassing 20%) during an early-September dip in the market. Higher nominal rates reflect higher inflation expectations following the May-June fall in the exchange rate. Nominal rates have also been nudged upwards by the Turkish Treasury's need for large-scale redemptions in September, as well as market concerns about the global outlook. Higher rates are still manageable; Turkish Treasury has a strong cash position and the declining trend in interest rates is likely to resume soon.

16. (SBU) The resumption of nominal rates' declining trend will depend on a return to disinflation. With the fall in the exchange rate and higher fuel prices working to keep inflation high, the annualized inflation rate returned to the low double digits in the summer months. Markets are now hoping inflation will start coming down again in the fall, given the Central Bank's cautious stance.

17. (SBU) In July, in the immediate aftermath of the fall in the exchange rate and the increase in interest rates, there was a consensus among economists that there would be a significant slowdown in economic growth in the second half of the year. Private investment and interest-rate sensitive consumption -- autos, housing, consumer durables -- have been major drivers of Turkey's

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strong growth from 2002 through the first half of 2006. The most recent data releases, however, suggest that the slowdown may not be as pronounced as previously thought and that growth is likely to surpass the 5% program target for the full year.

18. (SBU) The balance of payments outlook for 2006 is mixed, with a current deficit probably surpassing 7% of GDP. On top of a still weak trade account, tourism receipts now look slightly down this year, particularly following the recent spate of terrorist bombings. Still, the current account deficit does not seem a serious concern in the near-term, as Turkey has ample financing for it: strong FDI flows are set to surpass last year's record \$9.6 billion by \$10 billion or more and portfolio investors have returned.

Political and EU Wrangling Likely

19. (SBU) Even as the macro picture looks more comfortable, the same contentious domestic political atmosphere that helped drive investors away in May will continue to be a risk in the run-up to May 2007 presidential elections and parliamentary elections, which must be held by November 2007. A sign of the underlying political seething was the bitter debate over Turkey's participation in UNIFIL that pitted the Kemalist secular establishment - led by President Sezer and the vocal leading opposition party -- against the AK Party Government.

110. (SBU) Turkish participation in UNIFIL, along with the Rice-Gul announcement in July of the Shared Vision and Structured Strategic Dialogue, have helped U.S.-Turkish bilateral relations, despite the exceedingly poor USG image in Turkey, as reflected in the German Marshall Fund's Transatlantic Trends and other recent surveys. Ongoing PKK terrorist violence continues to roil bilateral relations, and is topic number one domestically. The recent naming of General (ret) Ralston as the U.S. special envoy to combat PKK terrorism has helped, but Turkey is still looking for concrete action against the PKK in Iraq.

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